IRS And US Treasury Release Proposed Regulations Under FATCA

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On February 8, 2012, the IRS and US Treasury released 389 pages of proposed regulations under the Foreign Account Tax Compliance Act (FATCA), which was enacted for the purpose of combating offshore tax evasion. To achieve this goal, FATCA imposes a non-refundable withholding tax (FATCA withholding) of up to 30% (subject to exemptions or reduced rates by reason of an applicable US tax treaty) on certain payments to any “foreign financial institution” (FFI), unless the FFI reports certain information about financial accounts held by US persons, or by other non-US entities in which US persons hold a substantial ownership interest.

In the course of preparing the proposed regulations, the IRS received extensive comments from more than 150 organizations, including virtually all of the major international trade associations of banks, fund managers, swap dealers, and custodians, as well as many foreign governments and individual financial institutions.

FFIs that do not participate in FATCA, i.e, non-participating FFIs (NPFFIs), will be subject to FATCA withholding on (i) US-source interest, dividends, rents, royalties, insurance premiums, and other fixed or determinable annual or periodical gains, profits and income; (ii) gross proceeds from the sale of US debt and equity securities; and (iii) foreign-source payments from other FFIs to the extent attributable to their US assets (each, a withholdable payment).

To avoid FATCA withholding, an FFI can become a participating FFI (PFFI) by entering into an agreement (an FFI agreement) with the IRS to (i) identify its US investors; (ii) identify investments by non-US entities in which US persons hold a substantial ownership interest; (iii) report certain information to the IRS regarding such investors; (vi) verify its ongoing compliance with its obligations pursuant to the FFI agreement; and (v) make the appropriate withholding on withholdable payments made to investors that do not provide the required information (recalcitrant holders) or that are themselves NPFFIs.

This alert summarizes some of the key implementation issues relevant to the asset management industry, including deadlines and the impact of non-compliance.

Complying with FATCA

For fund managers, a first step toward FATCA compliance would include an initial review of the fund structure in order to identify FFIs. This will likely include most non-US entities that make investments, since the proposed regulations define “FFI” broadly to include non-US entities that are engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities or derivatives.

Next, fund managers will need to identify, for each FFI: (i) US investors; (ii) investors that are non-US entities with one or more significant US owners; and (iii) investors that are themselves FFIs.

For investors that are individuals or entities that are not themselves FFIs, the proposed regulations have implemented certain rules intended to simplify the due diligence process:

- pre-existing investments of individuals of $50,000 or less, and pre-existing investments of entities of $250,000 or less, may be excluded from due diligence procedures;
- fund managers may rely on information gathered in the context of “anti-money laundering”/”know your customer” rules;
- electronic review of pre-existing investments of $1 million or less is allowed – further documentation is required only if electronic review reveals certain “US indicia” suggesting that that the owner may be a US person; and
- manual review of paper records is generally required for investments that exceed $1 million.

An investor that is itself an FFI must provide proof that it is either a PFFI or a “deemed-compliant” FFI (a limited category of FFIs that have been determined to not pose a significant risk of tax avoidance and, consequently, have been exempted from FATCA). If an investor that is itself an FFI does not provide such proof, such FFI is an NPFFI and the fund will be required to apply 30% withholding on any withholdable payments made to such NPFFI beginning January 1, 2014 (and on any “passthru payments” that are not withholdable payments beginning January 1, 2017).

FFIs seeking PFFI status in time to avoid FATCA withholding will be required to execute an FFI agreement with the IRS by June 30, 2013. The IRS intends to release a draft model FFI agreement in early 2012 and a final model FFI agreement in late 2012. Once an FFI enters into an FFI agreement, it will have two years from the effective date of the agreement to request and obtain the documentation required to establish the US status of each pre-existing account, subject to the *de minimis* limits and due diligence rules mentioned above. An FFI agreement not only applies to the US accounts of the PFFI, but also to the US accounts of each additional FFI that is a member of the same expanded affiliated group.

Thus, each FFI within the fund structure (and therefore, a member of the expanded affiliated group) must be a PFFI or deemed-compliant FFI in order for any one FFI in the expanded affiliated group to become a PFFI.

The proposed regulations have provided a transition period, ending January 1, 2016, for the full implementation of this requirement on expanded affiliated groups. During the transition period, therefore, an NPFFI will not prevent other FFIs within the same expanded affiliated group from entering into an FFI agreement, provided that the NPFFI agrees to perform due diligence to identify its US accounts, maintain certain records, and meet certain other requirements.

In addition to the diligence and reporting requirements, the FFI agreement will also require PFFIs to commit to ongoing compliance with FATCA obligations. Therefore, fund managers should establish compliance procedures that will assist them in maintaining their PFFI status.

Because of the administrative burden of maintaining PFFI status, fund managers may also consider establishing certain funds that do not accept US investors. In such cases, the diligence and reporting obligations would be significantly reduced, but such funds still would need to establish and disclose the fact that they have no US investors in order to maintain PFFI status. Simply closing the door to US investors would not, on its own, shield an FFI from FATCA withholding.

From the investment perspective, each FFI should determine if unrelated funds and entities in which it may have invested are FFIs. If such funds are not PFFIs, US-source withholdable payments made to such entities may be subject to the 30% FATCA withholding, thereby reducing the amount available for further distribution to funds within the fund structure. In order to avoid this outcome, fund managers may want to scrutinize potential investments to ensure that if investment is made in a fund-of-funds structure, downstream funds are PFFIs or deemed-compliant FFIs.

Effect of Non-Compliance

For a fund, there are two possible ways to be non-compliant. First, an FFI that does not enter into an FFI agreement is an NPFFI subject to the 30% FATCA withholding on withholdable payments and passthru payments. Furthermore, any FFI that is treated as a partnership for US federal income tax purposes may be entitled to a refund or credit on its FATCA withholding to the extent such amounts are allocable to investors that are “exempt beneficial owners” under the FATCA rules (e.g., US tax-exempt entities or foreign governments). Refunds and credits also will be allowed to the extent an FFI is entitled to an exemption or a reduced rate of tax by reason of an applicable US tax treaty.

Second, a US fund and a PFFI will be obligated to withhold on distributions made to NPFFIs and/or recalcitrant holders, as applicable. The proposed regulations have broadly defined the term “withholding agent" to include any person, in whatever capacity, that has the control, receipt, custody, disposal or payment of a withholdable payment; therefore, US funds and PFFIs can be withholding agents (unless, in the case of a PFFI, its FFI agreement provides otherwise). In general, withholding on withholdable payments is expected to be mechanically similar to withholding on payments to foreign persons under sections 1441 and 1442 of the Code, and will work in tandem with the requirement, under the proposed regulations, that withholding agents must report (to both the IRS and to payment recipients) all withholdable payments subject to FATCA withholding (whether or not actually taxed) that have been paid by such withholding agent during a year.

A withholding agent will be subject to certain presumptions and standards of knowledge when determining the status of a payee. Any withholding agent that fails to withhold and deposit the appropriate FATCA withholding amounts will be liable for such taxes and applicable penalties and additions to such taxes. In addition, a withholding agent that cannot reliably associate a withholdable payment with the proper FATCA exemption documentation also will be liable for any uncollected FATCA withholding.

Joint Statement

Simultaneously with the release of the proposed regulations, the US Treasury, along with the governments of France, Germany, Italy, Spain and the United Kingdom, released a joint statement regarding the adoption of an alternative reporting approach, whereby an FFI may be able to satisfy its FATCA compliance obligations by reporting directly to its country of residence. Any such agreements are not intended to remove an FFI's reporting obligation under FATCA, but may simplify the reporting process.

If you would like additional information about FATCA, please contact Richard Schaul-Yoder, Sharon C. Lincoln, Flora Brookfield or Kip Cawley of Foley Hoag's Tax Group or your lawyer at Foley Hoag.

IMPORTANT DEADLINES UNDER PROPOSED FATCA REGULATIONS

2013

- FFIs may begin to apply to enter into FFI agreements

2014

- FATCA withholding begins on withholdable payments
- PFFIs must report limited information relating to US accounts (name, address, TIN, account number, account balance)

2015

- FATCA withholding extended to payments of gross proceeds from the disposition of property that can produce US-source interest and dividends
- PFFIs must begin filing modified Forms 1042 and 1042-S

2016

- All entities and branches within the same expanded affiliated group must be fully compliant with FATCA in order for any one member to be a PFFI.
- PFFIs must report income associated with US accounts and payments to NPPFIs.

2017

- FATCA withholding begins on foreign passthru payments
- PFFIs must report all information required under FATCA with respect to US accounts (including gross proceeds from broker transactions)